

ANALYSIS OF ORIGINAL BILL

Author: Hayden Analyst: Roger Lackey Bill Number: SB 1435
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 01-26-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Minimum Tax/Qualified New Small Corps/Cost Of Administration/Audit Bureau
Determines

SUMMARY

This bill would require that any domestic bank or corporation that is both a qualified new corporation and qualified small business pay a minimum tax that is equal to but not higher than the actual costs incurred by a state agency associated with incorporating a new business entity, as determined by the Bureau of State Audits.

EFFECTIVE DATE

This bill would be effective January 1, 1998, and apply to certain minimum tax payments for income years beginning on or after January 1, 1999.

LEGISLATIVE HISTORY

SB 842 (1997), SB 510 (1997), AB 8 (1997), AB 27 (1997), SB 38 (Stats. 1996, Ch. 954), AB 546, AB 3298, AB 3010, AB 3394 (1996); AB 647, AB 744, AB 1098 (1995); AB 411, AB 977, AB 1721, AB 2886, AB 3807 (1993/94); AB 3506, SB 1453 (1992); AB 4275 (1989/90); SB 572 (Stats. 1987, Ch. 1139); AB 1 (Stats. 1971, Ch.1); AB 1175 (Stats. 1957, Ch. 1127).

PROGRAM HISTORY/BACKGROUND

The minimum franchise tax was established to ensure that all banks or corporations pay at least a minimum amount of franchise tax for the privilege of doing business in this state, regardless of the bank's or corporation's level of income (or loss). The minimum franchise tax has varied over the years. For income years ending before June 25, 1959, the minimum franchise tax was \$25. For income years ending after June 25, 1959, and beginning before January 1, 1972, the minimum franchise tax was \$100. For income years beginning after December 31, 1971, and before January 1, 1987, the minimum franchise tax was \$200. For income years beginning after December 31, 1986, and before January 1, 1989, the minimum franchise tax was \$300 (SB 572, Stats. 1987, Ch.1139). This tax was increased to \$600 for income years beginning on or after January 1, 1989,

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director

Gerald H. Goldberg

3/2/98

Agency Secretary

Date

By:

Date:

and before January 1, 1990, and to \$800 for income years beginning on or after January 1, 1990. Beginning on January 1, 1997, "qualified new corporations," as defined, with estimated gross receipts of less than \$1 million are required to prepay a \$600 minimum franchise tax in lieu of the \$800 minimum franchise tax.

The minimum franchise tax is \$25 for certain gold and quicksilver mining corporations. Credit unions, certain nonprofit cooperative associations, and domestic banks and corporations which have filed a certificate of dissolution are not subject to the minimum franchise tax.

Taxpayers are required to pay the minimum franchise tax for their first taxable year to the Secretary of State at the time they incorporate (California corporation) or initially qualify (non-California corporation) with that office to do business in this state. This initial payment constitutes the taxpayer's initial return. Because the taxpayer has no prior income year on which to measure the tax, the only tax due for the first taxable year is the prepaid minimum franchise tax.

Prepayment of the second year's minimum tax is due during the corporation's first year. At the end of the first year, even if it is not a full 12 months, taxpayers are required to compute their franchise tax for the privilege of conducting business during the second taxable year based on a measurement of the first year's net income. The taxpayer must file a corporate franchise tax return within two months and 15 days after the end of the first year and include payment of the taxes due for the second taxable year. The franchise tax for each subsequent taxable year is computed based on a measurement of the preceding year's net income. Under the rules for payment of estimated taxes, four equal payments are to be made during the current year for the privilege of exercising a corporate franchise in the subsequent year, but the first payment cannot be less than the \$800 minimum tax.

SPECIFIC FINDINGS

Under existing state law, every bank and corporation that is organized or qualified to do business or is doing business in this state (whether organized in-state or out-of-state) is subject to the minimum franchise tax. Taxpayers must pay the minimum franchise tax only if it is more than their measured franchise tax. For income years beginning on or after January 1, 1997, only taxpayers whose net income is less than approximately \$9,040 pay the minimum franchise tax because their measured tax would be less than \$800 ($\$9,039 \times 8.84\% = \799).

Existing state law provides that real estate mortgage investment conduits (REMICs) are subject to and required to pay the minimum franchise tax. Regulated investment companies (RICs) and real estate investment trusts (REITs) organized as corporations also are subject to and required to pay the minimum franchise tax.

Existing state law requires nonprofit charitable organizations to file periodic reports with the Attorney General. For any year that a nonprofit charitable organization does not file with the Attorney General and the Attorney General notifies the department of this failure, the nonprofit charitable organization is assessed and required to pay the minimum franchise tax.

Under existing state law, the tax on limited partnerships (LPs), limited liability companies (LLCs), and limited liability partnerships (LLPs) is set at \$800 by reference to the amount provided in the minimum franchise tax statute.

Existing state law provides a reduced minimum franchise tax of \$600 for "qualified new corporations" with gross receipts, less returns and allowances, reportable to this state of less than \$1 million. The reduced tax applies only to the first taxable year commencing on the date the corporation is incorporated.

Also, **existing state law** provides that the determination of whether a corporation meets the gross receipts criterion is based on the aggregate gross receipts of the members of a commonly controlled group. The law defines "gross receipts less returns and allowances reportable to this state" as including both business and non-business receipts.

The reduced minimum franchise tax does not apply to any corporation if 50% or more of its stock is owned by another corporation. In addition, it does not apply to certain entities such as limited partnerships, limited liability companies, and charitable corporations required to pay the minimum franchise tax as a result of failure to file with the Attorney General.

The corporation pays an additional tax of \$200 on the due date of its first return, without regard to extension, if the corporation's gross receipts exceed \$1 million or its tax liability exceeds \$800.

This bill would require that any domestic bank or corporation that is both a qualified new corporation and a qualified small business pay a minimum tax that is equal to but not higher than the administrative costs incurred by a state agency associated with the incorporation of a new business entity, for the first two income years.

This bill would require the Bureau of State Audits to determine the actual cost incurred by any state agency associated with the incorporation of a new business entity and to report that amount to the Legislature on or before January 1, 1999.

This bill would define "qualified small business" as a business with 25 or fewer employees, and gross receipts, less returns and allowances, of less than \$1 million during the income year, and a tax liability not greater than \$800.

This bill would not apply to any qualified small businesses that reorganized solely for the purpose of reducing its minimum tax obligation.

This bill would apply to qualified small businesses that incorporate on or after January 1, 1999.

Policy Considerations

This bill would provide that domestic small corporations will pay less tax than foreign small corporations doing business in California. If enacted, this bill could be challenged as an unconstitutional violation of the Equal Protection Clause.

Implementation Considerations

This bill twice describes the guidelines required to be a "qualified small business." Amendment 1 would eliminate duplicate language in the bill, clarify that the "first two income years" would include the initial prepayment to the Secretary of State, and would eliminate the term "bank" which is included in the definition of "corporation."

This bill would require the Bureau of State Audits to report its findings to the Legislature on or before January 1, 1999. If the Bureau of State Audits findings are reported close to or on January 1, 1999, it would be difficult for the Franchise Tax Board to implement immediately the programs necessary to comply with this bill.

This bill would require that a corporation must have 25 or fewer employees, in addition to the other guidelines, to qualify as a "qualified small business." It would be difficult for the Franchise Tax Board to determine which corporations meet this qualification.

Refunds might have to be made to qualified small businesses that incorporated on or after January 1, 1999, and prepaid \$600 to the Secretary of State instead of the new minimum franchise tax for qualified small businesses, which might not be set until after that date. Issuing any refunds would create a minor additional workload for the department.

This bill would provide that minimum franchise tax for "qualified small businesses" is equal to the actual costs incurred by the state to administer the minimum tax provisions. The actual costs could change each year, yet it is unclear if the bill would require the Bureau of State Audits to determine the actual cost only once or each year thereafter.

Technical Consideration

Amendment 2 is suggested to allow the language of the bill to be consistent with the "\$1 million or less" requirement for "qualified new corporations."

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill cannot be determined until the Bureau of State Audits findings are reported to the Legislature. However, for the 1998 income year, it is expected that approximately \$40 million of tax revenue will be received from approximately 32,700 "new qualified corporations" that pay a reduced prepayment to the Secretary of State of \$600 and a second year minimum franchise tax of \$800.

Senate Bill 1435 (Hayden)
Introduced January 26, 1998
Page 5

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1435
As Introduced January 26, 1998

AMENDMENT 1

On page 4, strikeout lines 4 to 17, and insert:

- (e) Notwithstanding subdivision (a), for income years commencing on or after January 1, 1999, every domestic corporation that is both a qualified new corporation and a qualified small business, as provided in subdivision (g) of Section 23221, shall pay a minimum tax equal to an amount that is no higher than the amount required to pay for the costs of administration of those minimum tax provisions as determined by subdivision (f) of Section 23221. This subdivision shall apply for the first two income years, which includes the year for the initial prepayment required under Section 23221, after the corporation's incorporation.

AMENDMENT 2

On page 6, lines 20 and 21, strikeout "of less than one million dollars (\$1,000,000)" and insert:

of one million dollars (\$1,000,000) or less